



**Remarks by Superintendent Julie Dickson  
Office of the Superintendent of Financial Institutions Canada (OSFI)  
To the Actuaries Club of Toronto**

**Toronto, Ontario  
September 23, 2009**

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## **Evolving Role of the Actuarial Profession**

### **Introduction**

I would like to thank Charles McLeod, Chair of the Actuarial Standards Board (ASB) for the opportunity to speak to you today.

In these turbulent economic times, actuaries both in Canada and abroad, are playing an increasingly important role in the proper functioning of financial service businesses. In Canada, the profession is uniquely recognized in legislation related to insurers. However, the pace of change today is unrelenting, and the profession needs to constantly re-examine its evolving role.

And that is what I want to discuss today: how the actuarial profession is evolving to embrace a wider and more important role in risk management; the importance of more frequent and rigorous stress testing; better integrating the roles of the Chief Risk Officer and the Appointed Actuary; and the growing importance of the CIA and Actuarial Standards Board to defend and maintain high risk management standards.

All of these issues are very important to OSFI given our reliance on the work of your profession.

### **Challenges Facing the Insurance Sector**

The global financial crisis has led to a lot of reflection about how risk was managed in the financial services sector in the years leading up to the crisis. While the centre of the crisis was the banking sector, risk management practices in insurance companies worldwide have also come under the microscope.

Further, the Financial Stability Board (FSB) and G-20 have been very clear in saying that – “the regulatory and oversight framework should strive to treat similar institutions and activities consistently” (pg ii, G-20 Working group 1 report, March 25, 2009). So even if insurance companies were not at the centre of the storm, they will be included as recommendations for regulatory reform are made.

On top of that, the insurance industry worldwide is bracing for some fundamental changes in insurance accounting down the road. Phase 2 changes under

International Financial Reporting Standards (IFRS) are yet to be defined, but they will be fundamental.

In addition, capital requirements are being overhauled with Solvency 2 in Europe and the adoption of more risk sensitive approaches being developed in Canada.

So this is an exciting time to be involved with the management of risk in an insurance company. And that's how we see actuaries – as managers of risk.

### Risk Management Expectations Rising Quickly

I have taken notice of the Enterprise Risk Management (ERM) initiatives being pursued by the Canadian Institute of Actuaries (CIA) and the broader international actuarial profession. The global development of an ERM professional designation – Certified Enterprise Risk Analyst (CERA) -- is a welcome and positive step forward.

But I think actuaries would be well served to sit up and take notice of the speed at which risk management expectations are changing. To me this means that the role of actuaries, Chief Risk Officers (CROs), and risk management committees of insurance companies are becoming bigger and there are more expectations regarding effectiveness.

For example, as a result of the global financial turmoil, most banks have made changes to ensure that CROs now report directly to the Chief Executive Officer (CEO). Many life companies are following suit and this is a development that I encourage.

It has also been agreed that banks and insurance companies must do a much better job of defining their risk appetite, and boards must be much more involved in approving and monitoring compliance with that risk appetite. I think pension plans should also consider paying closer attention to the long term impact of investment strategies on their ability to fulfill future obligations.

Many, such as the United Kingdom's Walker report, are suggesting the need for more industry experience on financial institution boards, which is something I have recently emphasized. The Walker report also suggests that the boards establish risk committees separately from the audit committee, which I wholeheartedly endorse.

Changes such as these mean that Appointed Actuaries (AAs) and CROs could get much tougher questions going forward – and there would probably be a lot more follow up of the answers you provide. Life is going to be more challenging for “experts”, and a premium will be placed on how well you can explain such things as actuarial reserves and capital.

## Stress Testing Expectations

Stress testing is another area where requirements are going up quickly. I understand that the International Actuarial Association is also currently working on a guidance paper on this topic.

New stress testing requirements have arisen because the global financial crisis called into question the stress testing that was done, and the attention paid to it by senior management and boards. You perhaps will have seen the following quotes during the current turmoil:

- In August 2007, Joseph Cassano, a former AIG executive referring to their credit default swap business said, "It is hard for us without being flippant, to even see a scenario within any kind of realm of reason that would see us losing one dollar in any of those transactions."
- In discussing the impact of the financial turmoil in 2008 Daniel Mudd, former chief executive of Fannie Mae said, "*Almost no one expected what was coming. It's not fair to blame us for not predicting the unthinkable.*"

Andrew Haldane from the Bank of England wrote this past February that a human failing he calls "*disaster myopia*"<sup>1</sup> is at least partly to blame. Haldane suggests that in choosing stress scenarios we have been too strongly influenced by the decade of favourable economic data prior to the turmoil, and in so doing we seriously under-estimated risk.

A simple example of this myopia occurs when we drive down the highway and pass an accident that has occurred. We react by slowing down and exercising caution, at least for the next few kilometres. However, as the distance from the accident increases, our feeling of confidence increases and our speed increases. Similarly as our distance increases from a previous crisis, our belief that those problems are behind us and the solutions found will continue to protect us, blind us to new and different dangers building around us.

Since the selection of future experience assumptions is fundamental to the work of actuaries you need to guard against the incursion of disaster myopia in your own work. We would not want the old analogy of an actuary driving down the road using only his rear view mirror to be applicable. Rather we need to use relevant past experience to help us better understand how risks might evolve in the future. Your challenge as actuaries is to learn from the past but like your motto says, you need to "see beyond risk".

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<sup>1</sup> *Why Banks Failed the Stress Test*, Andrew G. Haldane, Executive Director for Financial Stability, Bank of England, February 2009

## OSFI's Reaction

OSFI recently issued a new guideline for consultation which sets out OSFI's expectations with respect to stress testing. This applies to all financial institutions that we supervise, and is another step toward ensuring that stress testing through Dynamic Capital Adequacy Testing (DCAT) is seen as an important risk management tool, versus an esoteric actuarial requirement. OSFI also wants to see stress testing that is more frequent and that better integrates DCAT with new industry-wide stress testing.

OSFI's requirements, which reflect the Basel Committee's recently issued principles for sound stress testing, are focused on risk management. The principles include new concepts such as reverse stress testing. We want to see stress testing that includes events capable of generating the most damage, whether through size of loss or through loss of reputation.

A stress testing program should also determine what scenarios could challenge the viability of an institution and thereby uncover hidden risks and interactions among risks. More importantly we want to see management consideration and action as a result of the stress testing.

## Role of the Actuary in this New Environment

Given that the bar on risk management is going way up, the actuarial profession should consider where it fits in this new world. Traditionally you have been involved in the design, pricing and valuation of insurance and pension obligations. A question is whether you need to further strengthen and broaden your involvement in risk management.

In insurance companies, OSFI views the roles of CRO and Appointed Actuary as both being important and complementary to each other. We would expect large insurers or reinsurers to have both a CRO and AA. In comparing the two roles, it is clear that the CRO needs to have a broad view of all risks faced by the institution, including credit risk, market risk, operational risk, reputation risk and concentration risk.

The CRO needs to ensure that appropriate risk management strategies are in place, needs to have a solid awareness of capital management implications and needs to be a strong voice with regular reporting to the CEO and Board, which as noted earlier, requires an ability to communicate complex subjects in simple terms. We look to the CRO to be independent of the businesses within the financial institution while at the same time fostering the widespread development of Enterprise Risk Management (ERM) throughout the financial institution.

On the other hand, the Appointed Actuary has traditionally been considered as a separate "independent oversight function" with the authority to carry out their responsibilities and have direct access to the board as required under the Insurance Companies Act. The role has been about valuing an insurer's insurance obligations and assessing its financial condition.

While an actuary needs to act as an independent gate-keeper with the CEO and the Board (or Risk Committee), fulfilling a role similar to that of the Internal Auditor who reports to the CEO and the Audit Committee in all financial institutions, the CRO should be very aware of the impacts of the actuarial assumptions and the risk tolerance associated with them.

When considering insurance risks, such as segregated funds or longevity risks, OSFI expects the actuarial profession to develop appropriate views with respect to policy liabilities and related capital amounts. As we move towards more comprehensive risk management, actuaries will be involved in the determination of each insurer's own economic capital needs. To do this, actuaries will have to be more concerned about *all* the risks. While assessing liabilities has been a familiar "zone" for actuaries, it will be necessary to move outside that comfort zone and consider the entire range of risks faced by an insurer.

Thus the roles of the AA and CRO are vital and require a lot of interaction. The AA brings specialization on key issues while the CRO should be bringing an overall sanity check to risk assessment and control.

### Role of the CIA/ASB

OSFI has relied on the Canadian Institute of Actuaries (CIA) and the Actuarial Standards Board to set sound actuarial standards to ensure that policy liabilities and capital requirements accurately reflect the risk. The CIA in Canada has traditionally played a very important role in helping to ensure that needed work is done rapidly. But given today's business environment, the need for quick response has gone up, not down. Financial services is not a sleepy industry – it moves quickly and thus regulators need to move quickly and anyone who we rely on needs to move quickly – otherwise things slow down and risk can build.

Two areas that will have major implications for the life insurance industry -- the adoption of more risk sensitive approaches to Minimum Continuing Capital and Surplus Requirements (MCCSR) and the coming into force of IFRS 4 Phases 2 -- require considerable input by the actuarial profession.

In terms of IFRS, the Canadian Accounting Standards Board has decided to adopt the standards of the International Accounting Standards Board (IASB) beginning in 2011. Insurers need to be making adequate plans for the introduction of the first Phase of IFRS 4 in 2011. Because the liability method will not change significantly its impact has been expected to be fairly modest. However, now that the IASB is reconsidering IAS 39, the standard of financial instruments, the impact of the first Phase of IFRS 4 is not so clear.

Phase 2 changes, while not yet in final form, are beginning to take shape and they will be substantive and will be a fundamental shift for Canadian actuaries whose current standards have forcibly linked the valuation of the policy liabilities with the assets used to support them via the Canadian Asset Liability Method (CALM). This change from the direct linkage under CALM to one in which the assets and liabilities are valued independent of each other will cause insurers,

OSFI and actuaries to focus on how to ensure that risks continue to be managed, whether they be asset-liability mismatch risks or risks that policy liabilities are overestimated or underestimated.

A key issue for OSFI is always the degree of freedom given to actuaries to make assumptions. The CIA/ASB has delivered a high quality set of standards that served Canada extremely well. I sometimes hear that this set of high quality standards will not be needed or will disappear once IFRS comes into force. That concerns us. If ultimate IFRS standards in terms of actuarial-assumption setting are close to Canadian standards then the issue disappears, but if not, we need to consider next steps.

Prudent actuarial standards can make the difference when the unexpected happens. So we are on high alert in this regard and considering the options should we become uncomfortable with the situation from a safety and soundness perspective. There can be a very important role, under IFRS, for the CIA and the ASB to maintain solid practices in Canada while still following IFRS standards that are principle-based.

I expect that the Canadian actuarial profession is also addressing these questions and OSFI expects, as it has in the past, the profession to step forward and assist in finding appropriate answers. We need to work closely with the Actuarial Standards Board, the CIA, Insurance Bureau of Canada (IBC) and the Canadian Life and Health Insurance Association (CLHIA) to flesh out what needs to be done to maintain a strong and vibrant insurance industry after the introduction of IFRS 4 Phase 2.

## **Conclusion**

In conclusion, I want to reiterate and emphasize that:

- The bar is rising in all areas of risk management, and that includes actuaries;
- Stress testing and capital planning are two areas where more is being demanded from actuaries;
- Introduction of IFRS – especially phase 2 – presents challenges that the profession should embrace. There can be a very important role, under IFRS, for the CIA and the ASB to maintain solid practices in Canada while still following IFRS standards that are principle-based; and
- The global financial crisis provides actuaries with a tremendous opportunity to demonstrate value and expand their influence, effectiveness and impact.

Thank you.